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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1971

No. 71

In the Matter of TENNESSEE CENTRAL RAILWAY COMPANY, *Debtor*,
LOUISVILLE AND NASHVILLE RAILROAD COMPANY, ILLINOIS CENTRAL RAILROAD COMPANY, SOUTHERN RAILWAY COMPANY, *et al.*,
Petitioners,

v.

A. BATTLE RODES, Trustee of Tennessee Central Railway Company, *et al.*,
Respondents.

PETITION FOR A WRIT OF CERTIORARI

To the United States Court of Appeals for the Sixth Circuit

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INDEX

	Page
Opinions below	1
Jurisdiction	2
Questions presented	2
Statutes involved	3
Statement of the case	4
Reasons for granting the writ	8
Appendix:	
A. The Opinion of the Court of Appeals for the Sixth Circuit	A-1
B. Dissenting Opinion of Judge Paul Weick	A-16
C. The Opinion of the District Court	A-21
D. The Judgment of the District Court	47
E. The Order denying the Petition for Rehearing	53
F. The relevant sections of 77 of the National Bankruptcy Act (11 U.S.C., §205)	54
G. R.S., §3466 (31 U.S.C. 191)	56
H. 15 U.S.C., §603	57
I. The relevant sections of Reorganization Plan No. 1 of 1957, 22 F.R., §4633, 71 Stat. 647	58
J. Relevant section of §77 (1933), 47 Stat. 1474	60

Cases Cited

Mellon v. Michigan Trust Co., 271 U.S. 236 15
Southern Railway v. Flournoy, 301 F. 2d 847 (4th Cir. 1962) 5
United States v. Emery, 314 U.S. 423 13
United States v. Guaranty Trust Co., 280 U.S. 478 ... 15
United States v. Key, 397 U.S. 322 .....11, 13, 14

Statutes Cited

11 U.S.C., §77 .....3, 4, 6, 7, 8, 11, 12, 13, 14
15 U.S.C., §603 .....2, 3, 8, 9, 10
28 U.S.C., §1254(1) 2
31 U.S.C., §191 .....2, 3, 7, 9
49 U.S.C., §1233 12
Pub. L. 89-554, §8(a) (Schedule of Laws Repealed), Sept. 6, 1966, 80 Stat. 378 (Recodification of Titles) 2
Reorganization Plan No. 1, 1957, June 30, 1957, 22 F.R. 4633, 71 Stat. 647 .....2, 3, 8

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OPINIONS BELOW

The opinion of the Court of Appeals and the opinion of Judge Paul C. Weick dissenting from the denial of rehearing are not yet officially reported, but are set out in the Appendix to this petition at pages A-1–A-20.[1] The opinion of the District Court is set out in the Appendix at page A-21, and is reported at 316 F.Supp. 1103. The judgment of the District Court is set out in the Appendix at page A-47.

[1] The opinion of Judges Edwards and Peck, two members of the original panel assigned to this case, was filed February 2, 1972. The third member of said original panel, Judge Henry L. Brooks, died while the case was under consideration, on December 30, 1971. On the petitions to rehear, Judge Paul C. Weick was appointed to fill out the panel.

JURISDICTION

The opinion and order of the United States Court of Appeals for the Sixth Circuit was entered on February 2, 1972 (Appendix, pp. A-1–A-15); a timely petition for rehearing was denied on April 4, 1972 (Appendix, p. A-53). The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

QUESTIONS PRESENTED

1. Did the repeal, in the Reorganization Act of 1966[2] (nine years after the abolition of the RFC,[3] and nine years after the transfer of RFC notes to the Secretary of the Treasury), of 15 U.S.C., § 603, which expressly denied governmental priority under § 3466 to RFC loans of the type herein involved, suddenly endow such RFC notes with a priority status nonexistent over the years.

2. In any event, is § 3466 (31 U.S.C. § 191) applicable to railroad reorganization proceedings under § 77 of the Bankruptcy Act?

3. A third question was pretermitted by the majority opinion of the Court of Appeals;[4]

Are claims of connecting carriers for interline charges, accruing within six months before institution of reorganization proceedings under § 77, accorded priority in such proceedings, ahead of mortgagee claims, irrespective of whether or not there was diversion of current income?

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[2] Pub. L. 89-554, § 8(a) (Schedule of Laws repealed), Sept. 6, 1966, 80 Stat. 378; (Recodification of Title 5).

[3] Reorganization Plan No. 1, 1957, June 30, 1957, 22 F.R. 4633, 71 Stat. 647.

[4] The District Court held in petitioners' favor on this question and Judge Weick, in his dissenting opinion, concurred.

STATUTES INVOLVED

The relevant sections of § 77 of the National Bankruptcy Act (11 U.S.C. § 205), (App. A-54); § 3466 (31 U.S.C. § 191), (App. A-56); 15 U.S.C. § 603, (App. A-57); the relevant sections of Reorganization Plan No. 1 of 1957, effective June 30, 1957, 22 F.R. 4633, 71 Stat. 647, (App. A-58, 59); relevant portion of original § 77 (1933), 47 Stat. 1474, (App. A-60); are set forth in the appendix as indicated.

STATEMENT OF THE CASE

On December 14, 1967 the Tennessee Central Railway Company filed a petition for reorganization under § 77 of the Bankruptcy Act, thus invoking the jurisdiction of the United States District Court for the Middle District of Tennessee, Nashville Division. On September 22, 1969 the Trustee of the Debtor petitioned the District Court to determine, *inter alia,* the order of priority of various claimants. After a hearing, the court concluded that Petitioners herein, claiming recovery for interline balances[5] accruing within six months before the filing of the petition for reorganization, had priority over a claim asserted by the United States arising out of a loan to the Debtor by the Reconstruction Finance Corporation (RFC). The circumstances, in more detail, are not in dispute, and may be summarized as follows:[6]

On April 1, 1937, the RFC loaned the Tennessee Central Railway Company $5 million, the loan being secured by $5.5 million face amount of First Mortgage bonds of the railroad company. In 1953 the Tennessee Central, induced by promises from the Tennessee Valley Authority (TVA) of substantial coal purchases from certain coal fields in Putnam County, Tennessee, with the aid of further loans from the RFC totaling $2,148,900, bought substantial additional rolling stock and constructed an expensive line of track in Putnam County. A few months after these expenditures the TVA discontinued its coal purchases.

---

[5] Two of petitioners, with relatively small claims, are car rental companies.

[6] At the hearing before the trial court, at the Court's suggestion and by agreement, in lieu of presenting witnesses, affidavits of witnesses were filed by claimants and by the Government, said affidavits to be treated as testimony (Joint App., hereinafter referred to as J.A., pp. 20-21).

In January 1967 the Government agreed to extend the due date of its loans to December 31, 1967. At the time this extension agreement was reached, the Government was bound to have had full knowledge of the very precarious financial condition of the Tennessee Central. For the year 1966, the Tennessee Central had an operating deficit of approximately $1.2 million, and it experienced equally alarming deficits for the years preceding 1966.

In July and August of 1967, an official of the Tennessee Central contacted the Illinois Central, the Southern Railway, and the Louisville and Nashville Railroad Company[7] for the purpose of inducing those railroads not to draw a draft on the Tennessee Central for interline balances due said railroads and not to put the Tennessee Central on a prepaid basis. At that time the Tennessee Central had hopes of some financial rearrangement that would permit continued operations without the necessity of reorganization or liquidation in bankruptcy. At these talks there was recognition of the priority rights of the railroads' claims for interline charges accruing within six months prior to filing a bankruptcy or reorganization petition, pursuant to the so-called "Six Months Rule" (J.A. pp. 254/262). Representatives of some of the connecting carriers testified that such carriers did not put the Tennessee Central on a "prepaid" or "cash" basis until it became known that Tennessee Central was going to file in bankruptcy, because of their reliance on the principle announced in the case of **Southern Railway v. Flournoy**, 301 F. 2d 847 (4th Cir. 1962), and other similar decisions holding that claims of carriers in a reorganization proceedings are entitled to priority with respect to interline freight items and similar charges accruing during the six months preceding the filing of a petition for reorganization of a railroad (J.A. pp. 254/262).

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[7] The claims of these railroads were the largest interline balance claims and constitute the bulk of such claims in these proceedings.

All hope of refinancing fell through, and by late fall of 1967 bankruptcy was inevitable. The petition under § 77 and an order approving the petition were both entered December 14, 1967. The reorganization has resulted in the sale of the Debtor's rail lines to three connecting carriers with no substantial interruption of rail services (See 304 F. Supp. 289 (M.D. Tenn. 1969), with a total realization of approximately $3 million (J.A. pp. 4 and 17)).

As of March 24, 1972, the Government's claim on the RFC notes was $5,200,449.23 (J.A. p. 384)—far in excess of assets in the hands of the Trustee. If the priority asserted by the United States is sustained, Petitioners will receive nothing on interline balance claims totaling approximately $900,000.[8]

The District Court (William E. Miller, Circuit Judge, sitting by designation), held that Petitioners and certain other claimants were entitled to priority under the "Six Months Rule", stating:

> "Operating on a 'pre-paid' basis requires a greater degree of liquidity than financing on the 'collect' basis.
>
> • • • • • • • •
>
> "It is clear that the Tennessee Central would have been placed in serious financial difficulties if all shipments which it handled were placed on a 'pre-paid' basis by other carriers" (App. A-28).
>
> • • • • • • • •

[8] The character and importance of interline balances are particularly demonstrated in the Tennessee Central proceedings. For example, the T.C., being a very short line railroad, picked up many shipments to Chicago and beyond which it carried only a few miles and interchanged such shipments to the L&N or the Illinois Central. The T.C. collected the full freight tariff, even though it earned only a small fraction thereof, the balance being owed the connecting carrier.

> "The equities in this case favor the priority of the carriers. Their extension of credit preserved the corpus of the mortgaged railroad by maintaining it as a 'going concern' and at the same time enabling the area formerly served by the Tennessee Central to enjoy continued rail service, thereby carrying out the expressed purposes of the railroad reorganization section of the National Bankruptcy Act" (App. A-35).

The Trial Judge also held that § 3466 (31 U.S.C. § 191) was inapplicable to a railroad reorganization proceedings under § 77 of the Bankruptcy Act.

On appeal the decision was reversed. The Court of Appeals did not reach the issue as to the Six Months rule priority asserted by Petitioners, holding rather that § 3466 was applicable and that a decision on any other priorities was therefore unnecessary. A timely petition for rehearing was denied.

REASONS FOR GRANTING THE WRIT

The claims by Petitioners herein were denied by the court below by assigning a greater priority to the claim asserted by the United States under R.S. 3466. In so doing, the court has decided an issue of general importance in a way which is clearly contrary to the intention of Congress in two respects: (1) it permits a priority under § 3466 to debts arising from loans made by the Reconstruction Finance Corporation, which were expressly denied such priority by the Congress; and (2) it applies § 3466 in a § 77 reorganization, again contrary to Congressional intent. We deal with the two points in that order.

I

It is not in dispute that in Section 603 of Title 15, U.S.C., the Congress provided that "Debts due the (Reconstruction Finance) Corporation, whether heretofore or hereafter arising, shall not be entitled to the priority available to the United States pursuant to § 191 of Title 31 (R.S. 3466)" with exceptions not here relevant. The United States argues, however, that since the Reconstruction Finance Corporation was abolished by Reorganization Plan 1 of 1957 (22 F.R. 4633, 71 Stat. 647), and the RFC loan transferred to the Secretary of the Treasury, and since in the recodification of Title 5 of the United States Code in 1966, § 603 was repealed, the loan is now one to which § 3466 applies. Such was the view of the court below.

The argument is subject to at least two fatal flaws. First, the Reorganization Plan itself provided (Section 2(d)) that the Secretary of the Treasury as transferee from the RFC was vested only with the same "powers, authority, rights and immunities now vested in or avail-

able to the corporation . . .". In 1957, when the transfer occurred, it is undeniable that the loan to Tennessee Central carried no § 3466 priority; that was explicit in § 603. The subsequent repeal of § 603 is immaterial; the Secretary of the Treasury received only whatever rights were "now vested" in the RFC itself. To allow the loan a § 3466 priority now is obviously to contravene the conditions of the transfer.

Second, it is abundantly clear that Congress did not intend, by the recodification of Title 5, in which § 603 was repealed, to change pre-existing priorities of RFC loans. In the report of the House Judiciary Committee on the bill (H.R. Rep. No. 901, 89th Cong., 1st Sess.), the intention **not** to make substantive changes in the law is made express (p. 1):

> "The purpose of this bill is to restate in comprehensive form, *without substantive change*, the statutes in effect before July 1, 1965, that relate to Government employees, the organization and powers of Federal agencies generally, and administrative procedure, and to enact Title 5 of the United States Code" (Italics supplied.)

And again (p. 3):

> "*Substantive changes not intended.*—Like other recent codifications undertaken as a part of the program of the Committee . . . to enact into law all 50 titles of the United States Code, *there are no substantive changes made by this bill enacting Title 5 into law.*" (Italics supplied.)

The table of "Laws Omitted and Repealed" (Table II to the Committee report, pp. 251-519), contains the following note with respect to § 603 (p. 390): "Obsolete. Provided for powers of Reconstruction Finance Corporation, including appointment and pay of employees."

The Senate Committee report is to the same effect. S. Rep. No. 1380, 89th Cong., 2d Sess., p. 534.

In the light of this history, it is plainly at odds with Congressional intent to assert, as the United States must do, that the repeal of § 603 works a drastic change in the priorities attaching in this proceeding to the RFC loan. No change in substantive law was intended, and none was made because the Secretary of the Treasury received from the RFC no more in the way of priority rights than RFC had itself possessed. As the code revisors reported, § 603 was obsolete, because it was no longer necessary to define the nature of the RFC loans.

We submit that it is unreasonable to conclude that Congress, by such action nine years after the abolition of the RFC, intended to suddenly endow the United States with a debt priority, with respect to the remaining uncollected RFC notes, that the United States had not enjoyed over the intervening years. To hold that Congress, by abolishing the RFC, when its activities were reduced to liquidating functions, and transferring those functions to the Secretary of the Treasury, intended, in effect, to retroactively endow such loans with priority, is to clothe Congress with an undeserved motive of duplicity.

Of course, it is not disputed that 15 U.S.C., § 603 was removed from the statute books in the omnibus Reorganization Act of 1966, nine years after abolition of the RFC and the transfer of its functions to the Secretary of the Treasury. The removal or repeal of that section is not the issue. The important and determinative issue is: What is the legal effect, under the circumstances, of such belated removal of that section from the statute books? **That issue was not discussed at all in the majority opinion of the Court of Appeals.** The only discussion of that issue was in Judge Weick's dissenting opinion, which, in part, reads:

> "It was not until nine years later that Congress enacted the Omnibus Reorganization Act repealing hundreds of obsolete statutes, only part of which related to the RFC. We are asked to infer therefrom that Congress intended to restore priority of the United States, thereby displacing the lien of existing mortgage indebtedness of RFC, to the prejudice of priority creditors. It is not believed that Congress intended to do any such thing". (Appendix, p. A-17)

The issue is, of course, of importance beyond this case. Here, the error of the court below awards the entire Tennessee Central estate to the United States; petitioners' claims for $900,000[9] are wiped out.

Further, moreover, the decision on this question sets an important precedent as to governmental rights, inasmuch as it will determine the Government's rights with respect to other non-defense RFC notes in the hands of the Secretary of the Treasury and raises serious questions as to the equity of attracting participation of private capital by surrendering a statutory priority and subsequently, many years later, reclaiming such priority to the prejudice of non-governmental creditors.

II

The court below also erred, we believe, in holding that—apart from the special situation of RFC loans—§ 3466 was applicable in § 77 proceedings. The issue is one of first impression, and one of obvious importance in the administration of § 77. The District Court found § 3466 inapplicable; the court below reversed, but with a vigorous dissent by Judge Weick.

The court below felt compelled to its conclusion by the decision of this Court in **United States v. Key**, 397 U.S.

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[9] In addition other claims totalling approximately $300,000, including tax claims of certain counties and municipalities, are denied by the decision of the court below.

322, which held that § 3466 applied with respect to a tax claim by the United States in a Chapter X proceeding. With due deference, there is a world of difference between that case and the present one.

The purpose of § 77 is to maintain in operation, so far as possible, the existing rail transportation system. Such, too, was the purpose of the RFC loans which were made to many railroads during the difficult years following the enactment of § 77. While Chapter X of the Bankruptcy Act also sought to preserve going commercial enterprises which had fallen on bad times, it does not reflect the public interest in the maintenance of an essential national facility which is basic to § 77. This purpose is *pro tanto* frustrated if the railroads' ability to obtain credit from private sources is impaired.

The Government has made or guaranteed large loans to the railroad industry. The Treasury Department holds loans against railroads, guaranteed by the Interstate Commerce Commission, which are in default (49 U.S.C. 1233), in the amount of $73,987,000.[10] The priority status of such loans is vital to the railroad industry for at least two reasons: (1) If such Government loans have priority ahead of claims for interline balances under the "Six Months Rule", connecting carriers may be compelled, for their own protection, to place a debtor rail carrier which is a beneficiary of such a Government loan, and which is experiencing a cash shortage, on a "prepaid" status. In some circumstances, as recognized by the Trial Court, this could place the debtor road "in serious financial difficulties." (2) As stated above, such Governmental priority will seriously impair the railroad's ability to obtain credit from private sources.

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[10] Annual report of the Secretary of Treasury for fiscal year ending June 30, 1971, Statistical Appendix, p. 316.

We do not dispute the broad sweep of the language of § 3466, nor the teachings of **United States v. Emery**, 314 U.S. 423, that it is to be construed liberally and applied except where a later status is plainly inconsistent with it. Notwithstanding, we believe that it is not intended to apply in § 77 cases. In § 77 (11 U.S.C. § 205(b)) Congress has provided:

> "For all purposes of this section **unsecured** claims, which would have been entitled to priority if a receiver in equity of the property of the debtor had been appointed by a Federal court on the day of the approval of the petition, shall be entitled to such priority and the holders of such claims shall be treated as a separate class or classes of creditors." (Emphasis supplied).

The District Court's holding that § 3466 was inapplicable to § 77 proceedings was based on the above quoted provision. Chapter X has no similar provision. And under this section, which is the only section of § 77 dealing with priorities, the limitation is clear—priority is awarded only to **unsecured** claims which would have had priority in an equity receivership. The claim of the United States in this case is a **secured** claim, and to give such a claim priority over the unsecured claims of petitioners, which would have had priority in an equity receivership, is directly in conflict with the language of § 77(b).

As Judge Weick pointed out in his dissenting opinion, the majority opinion of the Court of Appeals "is based entirely on dicta in **United States v. Key**, 397 U.S. p. 322." However, such reliance of the lower court was erroneous because the dictum in the **Key** case indicating that § 3466 is applicable to § 77 proceedings relates to the original 1933 version of the Railroad Reorganization Act referred to by this court as the precursor of Chapter X. Section 77 was drastically amended and rewritten in 1935 (49 Stat. 911; 11 U.S.C. 205).

The Supreme Court in the **Key** case quoted § 77(e), as follows:

> " 'If the United States of America is directly a creditor or stockholder, the Secretary of the Treasury is hereby authorized to accept or reject a plan in respect of the interests or claims of the United States.' 47 Stat. 1478".

That provision was in the earlier version of § 77, **but that provision is not in the rewritten § 77 (1935).**

The Trial Court's holding that § 3466 was inconsistent with and inapplicable to the **present revised** § 77, relied upon and quoted 11 U.S.C. 205(b), quoted hereinabove, which is not **contained in the original (1933) version of § 77.**[11]

It is submitted, therefore, that the comments in the **Key** case, relating to the 1933 Railroad Reorganization Act and not the existing 1935 Act, does not constitute dictum of the Supreme Court applicable to the case *sub judice.* Judge Weick in his dissenting opinion said: "There is nothing in the court's opinion (opinion in the **Key** case) to indicate that it considered amended § 77" (Brackets added).

It is respectfully submitted that the majority opinion of the Court below erroneously construed the *dictum* in the **Key** case as applicable to the existing (1935) version of § 77, and that without a clarification by this Court of the meaning of its dictum, the opinion of the court below may lead other lower courts to compound that error and make erroneous rulings as to the applicability of § 3466 to § 77 proceedings—a most important question to the railroad industry.

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[11] The somewhat analogous provision of the 1933 version of § 77 omitted the word "unsecured." 47 Stat. 1474, Section (c), App. p. 60.

Moreover, as the dissenting judge below pointed out, the RFC Act itself evidenced an intention by Congress that § 3466 was not to apply. That Act created other and specific means by which to secure repayment of loans—by obtaining a lien, as was done here. The situation is closely analogous to that presented to the Court by the claim for § 3466 priority made by the United States for advances to railroads during and shortly after Federal control. The Court concluded that Congress had not intended § 3466 to apply, since it had provided other means of securing the Government's advances. **United States v. Guaranty Trust Co.**, 280 U.S. 478. And see, to the same effect, **Mellon v. Michigan Trust Co.**, 271 U.S. 236.

Judge Weick in his dissenting opinion stated:

> "In my opinion, to grant the United States priority would conflict with two decisions of the Supreme Court which held that claims of the Government for money loaned to railroads during federal control, were not entitled to priority. **United States v. Guaranty Trust Co.**, 280 U.S. 478 (1930), and **Mellon v. Michigan Trust Co.**, 271 U.S. 236 (1926)."

III

As stated hereinabove, the court below pretermitted the question as to the rights of connecting carriers to a priority for interline balances under the so-called "Six Months Rule". The District Court and Judge Weick in his dissenting opinion, having reached that question, found very strong equities justifying and requiring such priority. The challenge to this long existent priority principle by a litigant with the standing and status of the United States Government has caused deep concern in the railroad industry.

It is presumed that if certiorari is granted and the lower court reversed, that this third question will be remanded to the Court of Appeals, but, if this Court

should elect to pass on this question that it will so indicate and Petitioners will be afforded the opportunity to fully brief such issue in its brief on the merits.

CONCLUSION

The petition for certiorari should be granted. If either of the questions presented is resolved in favor of Petitioners, it will be appropriate to remand the proceeding to the court below to review the priority accorded Petitioners by the District Court, since a review of the challenge to that priority became unnecessary when the decision below in effect eliminated all claimants except the United States.

Respectfully submitted

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APPENDIX A

No. 71-1228

United States Court of Appeals
For the Sixth Circuit

In the Matter of:

Tennessee Central Railway Company, Debtor,

United States of America, Plaintiff-Appellant,

v.

A. Battle Rodes, Trustee of Tennessee Central Railway Company, Defendant-Appellee.

Appeal from the United States District Court for the Middle District of Tennessee.

Decided and Filed February 2, 1972

Before: Edwards, Peck and Brooks,* Circuit Judges.

Edwards, Circuit Judge. This is an appeal from a judgment entered in the United States District Court for the Middle District of Tennessee. The issue is whether the federal government has priority in a section 77 railroad reorganization proceeding (11 U.S.C. § 205 (1970)) for debts due it over the equitable priority accorded to "six months claimants."

The government claim is based upon a federal statute, 31 U.S.C. § 191 (1970) (R.S. § 3466), adopted in 1797 giving it priority as to debts due it in any bankruptcy proceeding. The contesting claimants assert equitable pri-

* Honorable Henry L. Brooks died on December 30, 1971.

ority because they furnished essentials to the bankrupt for the last six months of its operation before its insolvency.

In a well reasoned opinion the District Judge held that the Congressional purposes set forth in section 77 of the Railroad Reorganization Acts were better served by giving precedence to the equitable priority of the six months claimants. However, in *United States v. Key,* 397 U.S. 322 (1969) (a case not argued to the District Court), the United States Supreme Court, acting unanimously, emphatically affirmed the federal priority accorded by § 3466 in a Chapter X case also concerning a corporate reorganization, but one not involving a railroad. Although the Supreme Court plainly did not have our exact issue before it, there is a close analogy between the *Key* case and this one. In addition, the *Key* opinion discussed section 77 and commented, "Nothing in § 77 casts any doubt on the continued priority of the United States under § 3466." *United States v. Key, supra,* at 330.

The dictum just quoted, plus the strong analogy between the *Key* case and this case and the language of § 3466 itself all serve to convince us that we must reverse.

The Tennessee Central Railway Company was placed in reorganization under section 77 of the National Bankruptcy Act on December 14, 1967, after several years of operational losses. The Tennessee Central Railway Company has now ceased operations after selling all but a very small portion of its lines to three connecting railroads in 1968.

Appellees' claims in this case are for interline charges provided by three connecting railroads, taxes due to local governments, and some diesel oil, wood and similar types of supplies for TCR provided by various private corporations—all related to the six month period before the reorganization proceedings. They totaled approximately $3 million.

The United States Government claims arise from two Reconstruction Finance Corporation loans (never repaid) upon which the United States was owed approximately $5.5 million as of the time of reorganization. The principal claim of the United States Government was secured by liens upon the entire TCR bond issue which came due April 1, 1967. If given full effect, the United States claims would serve to wipe out any balance left in the hands of the Trustee after sale of TCR's assets to three of the railroads which previously connected with it.

The District Court, before whom the Trustee had filed a petition to determine classes of creditors and the priorities to be assigned to each, held that § 3466 was inapplicable to a section 77 proceeding and that the interline carriers, suppliers and local taxing authorities were entitled to priority over the claims of the United States.

The rationale which led to the District Court's result and that urged upon us by appellees may be summarized thus:

1) There is a great public interest involved in the continuing operation of railroads—more so than in continued operation of other private corporations.

2) Congress recognized this interest in the enactment of section 77.

3) In addition, in a paragraph of section 77 (77(b)), Congress referred to and sought to preserve aspects of the equitable receivership which created the six months creditor priority rule.

We approach decision of this case with the fact in mind that bankruptcy proceedings are among the topics specifically committed to Congressional power by the Constitution of the United States. Article 1 § 8 of the Constitution says in part:

"The Congress shall have power . . .
• • •

"To establish . . . uniform Laws on the subject of Bankruptcies throughout the United States; . . ."

As we have noted, the fundamental statute which we must construe in this case is R.S. § 3466 (31 U.S.C. § 191 (1970)) adopted in 1797. It provides:

"Whenever any person indebted to the United States is insolvent, or whenever the estate of any deceased debtor, in the hands of the executors or administrators, is insufficient to pay all the debts due from the deceased, the debts due to the United States shall be first satisfied; and the priority established shall extend as well to cases in which a debtor, not having sufficient property to pay all his debts, makes a voluntary assignment thereof, or in which the estate and effects of an absconding, concealed, or absent debtor are attached by process of law, as to cases in which an act of bankruptcy is committed. R.S. § 3466."

There can be no doubt that TCR, for purposes of this statute, is "a person indebted to the United States [who] is insolvent." Equally plainly the $5.5 million which TCR owed the United States is a "debt" within the meaning of this statute.

By its plain language § 3466 applies to this case. And the language "the debts due to the United States shall be first satisfied" is unambiguous and mandatory.

Appellees, however, rely, as did the District Court, upon section 77, passed in 1933, and more particularly on section 77(b):

"For all purposes of this section unsecured claims, which would have been entitled to priority if a receiver in equity of the property of the debtor had

been appointed by a Federal court on the day of the approval of the petition, shall be entitled to such priority and the holders of such claims shall be treated as a separate class or classes of creditors." 11 U.S.C. § 205(b) (1970).

The difficulty with appellees' argument is that section 77(b) contains no language arguably referring to or superseding the effect of § 3466. The situation here is much like that dealt with in *United States* v. *Emory*, 314 U.S. 423 (1941), where the Supreme Court set down the rules for interpreting § 3466:

"The applicability of § 3466 to this case is clear. The section applies in terms to cases '[1] in which a debtor, not having sufficient property to pay all his debts, makes a voluntary assignment thereof, or [2] in which the estate and effects of an absconding, concealed, or absent debtor are attached by process of law, . . .[or] [3] in which an act of bankruptcy is committed.' This case falls within the third category. It is agreed that the St. James Distillery was insolvent 'on or before August 1936' and that in response to a creditors' petition a receiver was appointed to liquidate the corporate assets. The appointment of a receiver under such circumstances is among the most common examples of an 'act of bankruptcy.' *Cf.* § 3(a) (4) of the Bankruptcy Act, U. S. C., Title 11, § 21(a)(4).

"Just such proceedings as this, therefore, are governed by the plain command of § 3466 that 'debts due to the United States shall be first satisfied.' The purpose of this section is 'to secure adequate public revenues to sustain the public burden' (*United States* v. *State Bank of North Carolina*, 6 Pet. 29, 35), and it is to be construed liberally in order to effectuate that purpose (*Bramwell* v. *U. S. Fidelity & Guaranty Co.*, 269 U. S. 483, 487). In view of this language, pur-

pose, and rule of construction, the priority asserted here by the United States appears to be securely established." *United States* v. *Emory, supra* at 426.

See also Small Business Administration v. *McClellan*, 364 U.S. 446 (1960). Both of these cases hold that only "the plainest inconsistency" would warrant an implied exception to § 3466.

The United States Supreme Court in its latest interpretation of the application of § 3466 to a Chapter X proceeding started with the *Emory* case:

"Thus, on the face of the statute, no inconsistency arises from applying both § 3466 and § 199 to Chapter X proceedings, much less the 'plain inconsistency' required if respondent is to prevail under the test of *United States v. Emory, supra*. That in itself strongly suggests that § 3466 should apply here, and our examination of the background and legislative history of § 199 and of Chapter X generally does not reveal a contrary intent on the part of Congress.

"Before the reorganization legislation of the 1930's, the principal method of reorganizing corporations that were unable to meet their debts was the equity receivership. This judge-made device was designed to preserve the debtor business as a going concern by cancelling claims against it, in return for which cancellation the claimants received debt or equity interests in a new corporation, which then acquired the assets of the old corporation in a judicial sale. See T. Finletter, The Law of Bankruptcy Reorganization 1-17 (1939). By 1926, it was established that § 3466 applied to give the United States an absolute priority for payment of debts due it from insolvent corporations in equity receivership. *Price v. United States*, 269 U. S., at 502-503, and see Blair, The Priority of

the United States in Equity Receiverships, 39 Harv. L. Rev. 1 (1925).

"In 1933, Congress enacted § 77 of the Bankruptcy Act, 47 Stat. 1474, providing a statutory procedure for the reorganization of railroads. Section 77, as well as later corporate reorganization statutes discussed below, was designed to follow the general format of the equity receivership. As one of the early commentators on the federal statutes has noted, '[t]he principles of the equity receivership underlie nearly every substantive provision of the [reorganization acts].' Finletter, *supra*, at 3. These statutes were not, of course, mere codifications of the law governing equity receiverships. They were designed in part to correct abuses and inefficiencies that had existed under the prior regime. *Duparquet Co. v. Evans*, 297 U. S. 216, 218-219 (1936). However, the problems of the equity receivership that led to the legislative intervention did not include the Government's priority under § 3466, a relatively uncontroversial aspect of the receivership procedure.

"Nothing in § 77 casts any doubt on the continued priority of the United States under § 3466. Indeed, the only provision in the new statute affecting the claims of the United States was § 77(e), which provided in pertinent part:

> " 'If the United States of America is directly a creditor or stockholder, the Secretary of the Treasury is hereby authorized to accept or reject a plan in respect of the interests or claims of the United States.' 47 Stat. 1478.

The purpose of this provision was to overcome the effect of two prior rulings of the Attorney General that the Secretary of the Treasury lacked authority to compromise claims of indebtedness owed to the

Government by the railroads, 33 Op. Atty. Gen. 423 (1923), 34 Op. Atty. Gen. 108 (1924).[8]

"[8] See Senate Committee on the Judiciary, Criticisms and Suggestions Relating to H. R. 14359 and S. 5551, Amending the Bankruptcy Act 19-20, 72d Cong., 2d Sess. (Comm. Print. 1933).

"In 1934, Congress enacted § 77B of the Bankruptcy Act, 48 Stat. 911, which provided a reorganization scheme for corporations generally, closely modeled on the railroad reorganization scheme of § 77; § 77B(e)(1) granted the Secretary of the Treasury power to compromise federal claims, in language almost identical with that of § 77(e). 48 Stat. 918. There is no language in the statute, and nothing in its history, to suggest any intention to alter the established priority of the United States under § 3466.

"In 1935, the Secretary of the Treasury called the attention of Congress to the fact that the courts were construing § 77B(e)(1) to include the United States among the general creditors in reorganization proceedings, so that plans disapproved by the Secretary for failure to satisfy a federal claim could nevertheless be confirmed if the necessary majority of general creditors approved. S. Rep. No. 953, 74th Cong., 1st Sess. (1935). The Secretary proposed an amendment, which, after some weakening in the House, see S. Rep. No. 1386, 74th Cong., 1st Sess. (1935), was adopted.[9]

"[9] The Secretary had proposed that he be given a veto over plans that failed to provide for 'payment' of *any* federal claim. See S. Rep. No. 953, *supra*. The House imposed the 'payment' requirement only upon tax and customs claims, possibly intending to leave the Government in the position of a general creditor with respect to other claims, see S. Rep. No. 1386, *supra*, and this was the form in which the amendment was adopted. Section 199 preserves this apparent distinction between tax and other claims, see text at n. 4, *supra*. However the courts, relying on the strong presumption against implied exceptions to § 3466, have not treated the Government as a general creditor in its nontax claims, but

rather have held that it has priority under § 3466. *United States v. Anderson*, 334 F.2d 111 (C.A. 5th Cir. 1964); *In re Cherry Valley Homes, Inc.*, 255 F. 2d 706 (C.A. 3d Cir. 1958); *Reconstruction Finance Corp. v. Flynn*, 175 F. 2d 761 (C. A. 2d Cir. 1949).

"If as appears from the present case, § 3466, if applicable, may, in some instances, give the Government greater protection than § 199, it would be anomalous to deny that protection to Government tax claims while granting it to nontax claims, since Congress clearly intended that tax claims should have greater protection.

49 Stat. 966 (1935). In its relevant provisions, the amendment was identical with present § 199, and the 1938 revisions which culminated in the replacement of § 77B by present Chapter X did not affect it.

"Thus § 199 is derived from an enactment designed to grant the Government the power to compromise its claims against debtors, and an amendment designed to ensure priority for federal claims over the claims of general creditors. Nothing in this background lends any support to respondent's claim that the draftsmen of Chapter X meant to provide an exception to the operation of § 3466 for reorganization proceedings under the new statute. Indeed the established practice of applying § 3466 to equity receiverships, the acknowledged predecessor of the Chapter X proceeding, combined with the failure to indicate in any way an intent to alter that practice in the new statutes, supports the conclusion that Congress affirmatively meant § 3466 to apply to statutory reorganization.[10]

"[10] The leading authorities agree that § 3466 applies to Chapter X proceedings. Finletter, *supra*, at 388-393; 6A Collier on Bankruptcy 269 n. 11 (14th ed. 1969).

"As we noted at the outset, § 3466 must apply according to its terms except where expressly superseded, or where excluded by a later enactment 'plainly inconsistent' with it. Here the statute literally applies, and no plain inconsistency with the scheme of

Chapter X appears. The terms of § 3466 are clearly not satisfied by the reorganization plan here in question, which provides payment in part to general creditors and other nonpreferred claimants[11] before

"[11] This case does not raise the question, never decided by this Court, whether § 3466 grants the Government priority over the prior specific liens of secured creditors. See *United States v. Gilbert Associates,* 345 U. S. 361, 365-366 (1953)" *United States v. Emory, supra* at 329-33. (Emphasis added.) (Footnotes in quotation.)

satisfaction of the federal tax claim. Therefore the judgment upholding the plan must be reversed, and the case remanded to the Court of Appeals for further proceedings consistent with this opinion."

The interpretative instructions of the Supreme Court underlined above, as well as the dictum referring squarely to section 77 proceedings, seem clearly to require the application of § 3466 to the instant case.

The most difficult problems of statutory interpretation pertaining to this issue, however, concern specific statutory language establishing or dealing with priorities which may be argued to conflict with § 3466. There is language in some cases which says that § 3466 "does not apply in bankruptcy" cases. *United States v. First National Bank & Trust of Fargo,* 386 F.2d 646, 648 (8th Cir. 1968); *Adams v. O'Malley,* 182 F.2d 925 (8th Cir. 1950); *In Re Taylor Craft Aviation Corp.,* 168 F.2d 808, 810 (6th Cir. 1948). Such language must be limited to the facts of the issues decided in the cases. It is clear, for example, that section 64(a) of the Bankruptcy Act does apply in conventional bankruptcies and is clearly inconsistent with the absolute priority of § 3466. This, of course, might lead to the conclusion that § 3466 was not applicable to conventional bankruptcies (as stated by the courts above) except for its possible incorporation as a fifth priority under § 64(a)(5).

When the Supreme Court in *Davis v. Pringle*, 268 U.S. 315 (1925), held that the United States was not "a person" within the meaning of § 3466 and that hence § 3466 was not incorporated into the fifth priority accorded by § 64(a)(5), Congress promptly amended § 64(a)(5) to make explicit its intention that § 3466 should apply. *See* the Chandler Act, June 23, 1938, 52 Stat. 874, amending 64(a)(5) of the Bankruptcy Act.

It appears clear, however, that § 64(a) does not apply to the chapters of the National Bankruptcy Act which do not deal with conventional bankruptcies, absent specific reference thereto. *See* 11 U.S.C. § 502 (1970), which generally applies the provisions of Chapters I to VII in Chapter X proceedings and then specifically excludes § 64(a) (11 U.S.C. § 104 (1970)) and 11 U.S.C. § 1059 (1970) which specifically applies § 64(a) to Chapter XIII proceedings. We conclude that Congress is thoroughly familiar with § 64(a) (as well as § 3466) and if it had intended it to apply to Chapter VIII dealing with railroad reorganizations, it would have said so.

Another somewhat difficult argument may be made concerning the following language included in Chapter VIII, 11 U.S.C. § 205(e) (1970):

> "*Provided further*, That if, in any reorganization proceeding under this section, the United States is a creditor on claims for taxes or customs duties (whether or not the United States has any other interest in, or claim against, the debtor, as creditor or stockholder), no plan which does not provide for the payment thereof shall be confirmed by the judge except upon the acceptance, certified to the court, of a lesser amount by the President of the United States or the officer or agency designated by him pursuant to the provisions of the preceding paragraph hereof:"

This provision, however, does no more than provide a very stringent method for compromise of federal tax or customs claims and as we see the matter, cannot appropriately be viewed as "plainly inconsistent" with the basic priority established by § 3466. We note legislative history language which can be argued to the contrary of this conclusion. Senate Rept. No. 1985, 74th Cong. 2d Sess. (1936); H.R. Rep. No. 2926, 74th Cong. 2d Sess. 6 (1936). In this regard, however, we find the actual language employed in the statute utterly inadequate to express any exclusion of § 3466. Further, in *United States v. Key*, 397 U.S. 322 (1969), dealing with a similar argument concerning similar language incorporated in Chapter X § 199, the Supreme Court said:

> "In approaching a claim of an implied exception to § 3466, we start with the principle, noted above, that the statute must be given a liberal construction consonant with the public policy underlying it. Applying that principle to an earlier claim that a statutory scheme implicitly excluded § 3466, this Court held that '[o]nly the plainest inconsistency would warrant our finding an implied exception to the operation of so clear a command as that of § 3466.' *United States v. Emory*, 314 U. S. 423, 433 (1941).
>
> "Here the Court of Appeals discerned an intent not to apply § 3466 to Chapter X proceedings from § 199 of the Bankruptcy Act, which forbids the approval of any reorganization plan which does not provide for the 'payment' of taxes or customs due to the United States, unless the Secretary of the Treasury accepts 'a lesser amount.'" *United States v. Key*, *supra* at 324-25. (Footnote omitted.)

After reciting other claimed bases for excluding application of § 3466 to Chapter X proceedings, the Court concluded:

"In our view these provisions are not logically inconsistent with the terms of § 3466, nor would they be rendered redundant if the older statute applied, nor does their language or legislative history reveal a purpose incongruous with its application." *United States v. Key, supra* at 326.

Again as to this issue, we feel that *United States v. Key, supra,* controls decision of our present case. If there be, as appellees argue, overriding policy and equitable considerations which cry for a different result, those contentions must be made before Congress for specific statutory amendments. *See* Plumb, *The Federal Priority in Insolvency: Proposals for Reform,* 70 MICH. L. REV. 1 (Nov. 1971) page 3.

As to appellee's Koppers Company, Inc., and the various city and county claimants for taxes, we note that these claims are founded primarily upon liens authorized by state statutes. It is, however, clear to us that federal and not state law controls both in determining priority and in determining whether the lien relied upon is "choate" or "inchoate." None of the liens relied upon in this record were the subject of proceedings designed to divest the debtor of either title or possession of its property prior to bankruptcy. *See United States v. Gilbert Associates, Inc.,* 345 U.S. 361 (1953); *Gordon v. Campbell,* 329 U.S. 362 (1946).

In *Gilbert* the Supreme Court said:

"In claims of this type, 'specificity' requires that the lien be attached to certain property by reducing it to possession, on the theory that the United States has no claim against property no longer in the possession of the debtor. *Thelusson v. Smith,* 2 Wheat. 396. Until such possession, it remains a general lien. There is no ground for the contention here that the Town had perfected its lien by reducing the property

to possession. The record reveals no such action. The mere attachment of the Town's lien before the recording of the federal lien does not, contrary to the holding of the Supreme Court of New Hampshire, give the Town priority over the United States. The taxpayer had not been divested by the Town of either title or possession. The Town, therefore, had only a general unperfected lien. *United States v. Waddill Co., supra*; *Illinois v. Campbell*, 329 U.S. 362, 370. Where the lien of the Town and that of the Federal Government are both general, and the taxpayer is insolvent, § 3466 clearly awards priority to the United States. *United States v. Texas*, 314 U. S. 480, 488." *United States v. Gilbert, supra* at 366.

The liens of appellees herein are not "specific and perfected liens." *United States v. Waddill, Holland & Flinn, Inc.*, 323 U.S. 353 (1945). They are general liens under federal law and § 3466 "clearly awards priority to the United States." *United States v. Gilbert, supra* at 366. *See also Illinois ex rel. Gordon v. Campbell*, 329 U.S. 362 (1946); *United States v. Texas*, 314 U.S. 480 (1941).

Since we believe that § 3466 and the recent interpretation of it in *United States v. Key, supra*, control this case, we have no occasion to analyze the government's other contentions to the effect that its claims are entitled to priority because there was no diversion of income such as to occasion application of the six months rule and that its claims were both secured claims and first in time.

We also note but reject appellees' assertion that we should find a controlling distinction between this case and the *Key* case in the fact that these debts to the United States are secured obligations arising from Reconstruction Finance Corporation loans, whereas the debts in *Key* were for federal taxes.

Federal claims which are secured by mortgage or lien are nonetheless "debts" within the meaning of § 3466 and hence entitled to priority thereunder. *Small Business Administration v. McClellan*, 364 U.S. 446 (1960); *W. T. Jones & Co. v. Foodco Realty, Inc.*, 318 F.2d 881 (4th Cir. 1963).

Further, although the application of § 3466 was originally excluded by the statute creating the Reconstruction Finance Corporation (15 U.S.C., § 603 (1970)), the R.F.C. was abolished in 1957 and its loans were transferred to the Secretary of the Treasury. The exclusion clause itself was repealed in 1966 by recodification of Title 5. Pub.L. 89-554, § 8(a), Sept. 6, 1966, 80 Stat. 648, 654, 655.

The judgment of the District Court is vacated and this case is remanded for further proceedings in accordance with this opinion.

APPENDIX B

Dissenting Opinion of Judge Paul C. Weick Entered April 4, 1972

Weick, Circuit Judge, Dissenting. This case is important to over $1,200,000 of creditors in railroad reorganization proceedings under Section 77 of the Bankruptcy Act, creditors whose priority claims were subordinated to the claim of the United States by the Court's opinion which reversed a judgment of the District Court[1] to the contrary. The case involves construction of the priority provisions of the Act, of the Reconstruction Finance Corporation Act as amended,[2] the applicability of R.S. § 3466, and the effect of the abolishment of R.F.C. and the repeal of statutes creating it.

Without question, the priority claims of the creditors were superior to the loan of R.F.C. which was secured by pledge of an issue of First Mortgage 4% Bonds. The United States claimed, however, and the Court held, that because of the abolishment of R.F.C. and repeal of the statutes many years after the loan was made, the Government need not look to the lien of its mortgage bonds, but could claim priority under R.S. § 3466, which the Reconstruction Finance Corporation Act, as amended, (and prior to its repeal) provided was inapplicable.

The Court's opinion is based entirely on dicta in *United States v. Key*, 397 U.S. 322 (1970); but *Key* involved a different type of proceeding, namely, a corporate reorganization under Chapter X of the Bankruptcy Act, rather than a railroad reorganization proceeding under Section 77, such as was involved in the present case. Counsel even question the validity of the dicta, pointing out that the

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[1] 316 F.Supp. 1103 (M.D. Tenn. 1970).

[2] 15 U.S.C. § 603.

court on page 330 quoted Section 77(e), as it existed prior to the Act's amendment in 1935, when the statute was rewritten entirely and drastically changed.

There is nothing in the Court's opinion to indicate that it considered amended section 77.

Furthermore, *Key* involved a tax claim of the United States. Our case, unlike *Key*, involved a loan made by R.F.C. to the railroad, which loan was secured by a pledge of $6,216,000 of First Mortgage 4% Bonds. At the time the railroad went into reorganization it owed the Government on the loan $4,571,000 in principal, and $461,731.13 in interest.

The statute creating R.F.C. granted it power to sue and to be sued, and expressly provided:

> "Debts due the Corporation, whether heretofore or hereafter arising shall not be entitled to priority available to the United States pursuant to section 191 of Title 31 (R.S. 3466) . . ."

In *Reconstruction Finance Corp. v. Menihan*, 312 U.S. 81 (1941), the Court refused to treat RFC as the United States, holding that costs could be assessed against it the same as against any other litigant.

RFC, however, was abolished in 1957 pursuant to provisions of the 1949 Reorganization Act (Ch. 226, p. 209) and Reorganization Plan No. 1 of 1957 (22 F.R. 4633, 71 Stat. 647), and its assets were transferred to the Secretary of the Treasury. See also 15 U.S.C.A. 601 and 603 notes.

It was not until nine years later that Congress enacted the Omnibus Reorganization Act repealing hundreds of obsolete statutes, only part of which related to the RFC. We are asked to infer therefrom that Congress intended to restore priority of the United States, thereby displacing the lien of existing mortgage indebtedness of RFC, to

the prejudice of priority creditors. It is not believed that Congress intended to do any such thing.

In my opinion, to grant the United States priority would conflict with two decisions of the Supreme Court which held that claims of the Government for money loaned to railroads during federal control, were not entitled to priority. *United States v. Guaranty Trust Co.*, 280 U.S. 478 (1930), and *Mellon v. Michigan Trust Co.*, 271 U.S. 236 (1926).

The purpose of the RFC loans to railroads was to keep the railroads in operation, to rehabilitate them, and to preserve the existing transportation system. It was a public purpose. This was also the purpose of the Railroad Reorganization Act (Section 77). The statute creating RFC provided specific means to insure repayment of loans other than the priority provision of § 3466. These means were strictly followed in the present case by a pledge of First Mortgage 4% Bonds to secure the loan.

While there was no express provision in the federal control statutes excluding indebtedness to the Government from the operation of § 3466, the Court held in *United States v. Guaranty Trust Co., supra* (280 U.S. 478), that Congress intended such exclusion. The Court said:

> "Moreover, Congress evidenced unmistakably its purpose to rely, for obtaining payment of the Government's advances, upon means other than the priority provided for by § 3466. Under all of the sections, the giving of adequate security was either required or left to the discretion of the President. Under § 210 no advance could be made, unless the Interstate Commerce Commission was satisfied that the earning power of the carrier and the security given furnished reasonable assurance that the loan would be repaid and all obligations in connection therewith would be performed. The interest rate required is much greater

than that which ordinarily accompanies even a business loan carrying such assurance of repayment as would have resulted from an application of the priority rule. Thus, both the general purposes of Title II and its specific provisions make it clear that Congress intended to exclude the indebtedness so arising from the scope of § 3466 of the Revised Statutes, just as under the Federal Control Act it had excluded therefrom claims incident to current operation of the railroads. *Mellon v. Michigan Trust Co.*, 271 U.S. 236, 240." (Id. at 485-486).

It is clear that railroads cannot operate without credit. The credit is necessary to obtain labor, materials and interline accommodations with other railroads; without such credit operations would cease.

It further appears from the record that RFC, as well as the Secretary of the Treasury, permitted the railroad to operate when they both knew that in so doing the railroad was incurring debts and losing substantial sums of money. By the continuous operation the mortgage security of the Government was preserved, and the trustee in the reorganization proceeding was enabled to sell the railroad as a going concern and without interruption of service to the public. The Government here was entitled to treatment no different than that accorded to any other secured creditor.

Equitable principles which are applied in creating priority liens of creditors under Section 205 for credit furnished within a period of six months prior to the reorganization proceeding, should be adhered to. *Southern Ry. v. Carnegie Steel Co.*, 176 U.S. 257 (1900); *Burnham v. Bowen*, 111 U.S. 776 (1884); *Miltenberger v. Logansport Ry.*, 106 U.S. 286, 311 (1881); *Southern Ry. v. Flourney*, 301 F.2d 847 (4th Cir. 1962).

Reliance upon cases such as *United States v. Emory*, 314 U.S. 423 (1941) and *Small Business Adm'n v. McClellan*, 364 U.S. 446 (1960), involving commercial loans to private individuals, is misplaced. There was no statute involved in these cases which excluded the operation of § 3466, or facts from which an intent on the part of Congress to exclude operation of § 3466 could possibly be inferred.

Nor was there involved in these cases a comprehensive scheme of Congress, as is evidenced by the Railroad Reorganization Act, to keep railroads in operation and to provide means for their rehabilitation which could be frustrated if the railroad's ability to obtain credit from private sources is impaired.

Substantial questions are presented in the appeal, and I respect the views of my colleagues. I would grant the rehearing and determine priorities excluding the operation of § 3466.

APPENDIX C

In the District Court of the United States
For the Middle District of Tennessee
Nashville Division

In the Matter of: Tennessee Central Railway Company, Debtor.	In Proceedings for the Reorganization of a Railroad No. BK 67-2263

OPINION

(Entered August 19, 1970)

On September 22, 1969, the Trustee of the Tennessee Central Railway Company, Debtor, petitioned this Court for a hearing on the division of stockholders and creditors into classes according to the nature of their claims, and a determination of the order of priority of such claims. A hearing on these issues was held on November 10, 1969.

The history of this action which is concerned with the reorganization and then the liquidation of the assets of the Tennessee Central Railway Company, will be found in this Court's opinion in In re Tennessee Central Railway Company, 304 F.Supp. 789 (M.D. Tenn., 1969).

There are four categories of creditors claiming all or a portion of the distributable assets of the Tennessee Central:

1. The United States Government, holder of the Tennessee Central's first mortgage bonds, secured by an indenture of mortgage.
2. Various railroads and other related companies claiming recovery for interline balances accruing within the period of six months before filing of the reorganization petition.

3. Municipalities and counties, claiming recovery for back taxes for periods prior to the filing of the reorganization petition.
4. Suppliers of cross-ties and diesel fuel to the Tennessee Central during the six months before the filing of the reorganization petition.

The present assets of the Tennessee Central, both in cash and in property not yet sold, total approximately $3,000,000. The claim of the government totals over $5,500,000. The claims of the carriers, and others claiming priority under the six-months creditors rule, total approximately $1,200,000. The various tax claims total over $80,000, and there are other suppliers' claims of more than $100,000.

Obviously, if the United States is given first priority in the recovery, its claim will consume all assets, and there will be no need to determine additional priorities.

Case law on the issues here presented is far from settled. While there are a few Supreme Court cases which touch upon relevant points, most of the published opinions are at the district court level. On some issues, conflicts exist among the circuits.

These reorganization proceedings are governed by the provisions of Section 77 of the National Bankruptcy Act, 11 U.S.C. § 205. It may be helpful at this point to quote from a general analysis of Section 77 contained in 5 **Collier on Bankruptcy** (14th Ed.), ¶ 77.02:

> Stated briefly, § 77 has for its main purpose "the rehabilitation of the debtor by a readjustment of its financial structure in the interest of the debtor and its creditors and security holders, under a fair and equitable plan of reorganization which shall so modify or alter the rights of both secured and unsecured creditors that the fixed charges shall be brought within the probable future earnings available for the payment

thereof." During the process of reorganization, the section contemplates the continued corporate existence of the debtor under the control and supervision of the court. Although § 77 does not depart from the general theory of the Bankruptcy Act that one of the main purposes is to permit the creditors to share in the debtor's assets, yet it should be borne in mind that the section reflects a public policy that the operation of railroads as sound, economic units should be achieved for the benefit of the public, regardless of the interests of creditors and stockholders. It has been vividly stated that under § 77 "the reorganized road shall be a living, not a dying, railroad enterprise" [Footnotes omitted].

Although no formal plan of reorganization has been filed during the proceedings, substantial compliance with the purposes of the act has been obtained. Virtually all of the Tennessee Central's line is now being operated by three other railroads, to whom portions of the bankrupt road were sold. Service has been maintained virtually to all areas previously served by the Tennessee Central. Since some of the claimants here have participated in the maintenance of service, the Court must take into consideration all factors which have contributed to this continuation of service.

The United States asserts a priority for its mortgage bonds under 31 U.S.C. § 191, a provision giving the United States a first priority in the assets "[w]henever any person indebted to the United States is insolvent . . . ." This is a general provision which has been in effect, substantially unchanged, since 1797. It has been held that this provision is inapplicable in conventional bankruptcy proceedings. Adams v. O'Malley, 182 F.2d 925 (8th Cir. 1950); *see* In re Taylorcraft Aviation Corp., 168 F.2d 808 (6th Cir. 1948) (dictum); United States v. First National Bank

& Trust Co., 386 F.2d 646 (8th Cir. 1967) (dictum). The United States contends, however, that its priority under 31 U.S.C. § 191 is to be afforded first position among the claimants by virtue of Section 77b of the National Bankruptcy Act, 11 U.S.C. § 205(b). Specifically, the last paragraph of section 205(b) provides in part:

> For all purposes of this section unsecured claims, which would have been entitled to priority if a receiver in equity of the property of the debtor had been appointed by a Federal court on the day of the approval of the petition, shall be entitled to such priority and the holders of such claims shall be treated as a separate class or classes of creditors.

As noted above, the general priority of the United States in the assets of its insolvent debtors does not apply in bankruptcy cases, and the same priority may not be integrated into the Bankruptcy Act to create priorities for the Government that are not placed there by Congress. *See* Davis v. Pringle, 268 U.S. 315 (1925) (claim under 31 U.S.C. § 191 not due priority in bankruptcy by integration with section 64 of the Act). Furthermore, section 205(b), *supra*, does not apply to secured claims. The government states in its Memorandum that:

> The debts due the United States by the Debtor insofar as they are based upon the notes now in excess of $5,500,000 were secured by a pledge of all the Debtor's first mortgage bonds. The mortgage bonds in turn were secured by a mortgage upon all of the Debtor's property both real and personal. [Memorandum at 9, 10]

It would appear that the claim of the United States is a secured claim and thus expressly excluded from section 205(b), which grants priority to certain unsecured claims only. The United States contends, nevertheless, that the restriction of 11 U.S.C. § 205(b) to "Unsecured claims"

does not bar its secured claim from the same priority. With this conclusion the Court is unable to agree.

It is further contended on this point that proceedings under the railroad reorganization sections of the National Bankruptcy Act are a substitute for reorganization under an equity receivership. *See* 5 Collier, Bankruptcy ¶77.02 (14th ed.) Thus, it is argued that the instant proceeding is akin to reorganization under an equity receivership and that the proper conditions thus arise for recognizing a claim under 11 U.S.C. § 205(b) as the Government as argued. Whether the United States under this theory would be entitled to a priority for an unsecured claim in this proceeding by virtue of section 205(b) need not be decided. For, as pointed out, section 205(b) is inapplicable to secured claims like that of the United States.

The assertion of a first priority in the United States under 31 U.S.C. § 191 is further attacked by the carriers presenting claims upon the authority of 15 U.S.C. § 603, which declares that debts due to the Reconstruction Finance Corporation (RFC) should not be afforded any statutory priority otherwise available to the United States. The carriers urge that this provision prohibits the United States from asserting the debts owed by the Debtor to the RFC as a basis for priority under 31 U.S.C. § 191. The statute relied on by the carriers was repealed by Congress in 1966. [Pub. L. 89-554, § 8(a), Sept. 6, 1966, 80 Stat. 648, 654-55.] The purpose behind the original statute is plain. Loans such as the one made to the Debtor by the RFC were intended to keep firms in desperate financial condition in business. These were to be considered regular commercial loans, and were to be treated accordingly in insolvency proceedings. It seems clear that if the Tennessee Central proceedings had occurred prior to the repeal of 15 U.S.C. § 603 in 1966 there could be no question that the United States would have no priority by virtue of

debts owed to the RFC. Inasmuch as 31 U.S.C. § 191 is inapplicable to bankruptcy proceedings, however, the result is still the same, and the Court can only speculate as to why the Congress would repeal the statute and enable the United States to have a debt priority in other cases that it had not enjoyed for thirty years.

The United States next contends that if its claim under 31 U.S.C. § 191 is denied, it is still entitled to be paid ahead of all other claimants by virtue of the mortgage lien which it has upon the property of the Tennessee Central. In opposition, the carriers answer that their claim is an equitable one, cognizable under the so-called "six-months creditors" rule, and should therefore come ahead of any claims which the United States might advance.

The six-months rule is a creature of equity. It was developed in railroad equity receiverships in the late 19th Century, and was designed to guarantee the payment of funds to certain creditors to whom the railroad in receivership had become indebted during the six months prior to the inception of the receivership. As the United States notes in its trial brief, "many inconsistencies exist among the lower courts' decisions in dealing with the rule."

There is no cut-and-dried "six-months rule." The Supreme Court has stated:

> It is apparent from an examination of the above cases [dealing with the six-months rule] that the decision in each one depended on its special facts. This court has uniformly refrained from laying down any rule as absolutely controlling in every case. . . . Southern R. v. Carnegie Steel Co., 176 U.S. 257, at 284-285 (1900).

One oft-quoted formulation of grounds for application of the rule appears in Guaranty Trust Company of New York v. Albia Coal Company, 36 F.2d 34, at 35 (8th Cir. 1929):

(1) That the consideration for the claim was a current expense of ordinary operation of the railroad, necessarily incurred to keep it a going concern.

(2) That the claim represents a debt contracted with the expectation or intention of the parties that it was to be paid out of the current earnings of the railroad.

(3) That the claim shall have accrued within six months prior to the appointment of the receiver.

In considering application of the six-months rule, it must be noted that the special facts of the Tennessee Central case make it unique, and not altogether analogous to other railroad reorganization proceedings. For some time prior to the filing of the reorganization petition the Tennessee Central had been in serious financial difficulties. The railroad showed operating losses in 1964, 1965, 1966, and 1967. Shortly before the railroad entered reorganization, it appeared to officers and directors of the Tennessee Central that it would be possible to obtain outside financial help to put the road on a sound footing once again, and enable it to pay off its quite considerable debt to the United States.

Of particular interest is the help the Debtor received in handling its interline freight balances. The interline freight balances for which the carriers assert priority under the six-months rule are not a portion of the Debtor's income which is owed the carriers for services rendered, but are rather funds which the Debtor collected for other carriers shipping over its lines, and are held by the debtor only as a type of collection agent for the carriers.

According to affidavits submitted by the various carriers, officials of the Tennessee Central contacted the carriers and asked that the railroad's interline accounts not be placed on a "pre-paid" basis until the road filed its

petition in reorganization. Operating on a "pre-paid" basis requires a greater degree of liquidity than financing on the "collect" basis. When freight is shipped over two or more railroads on a "pre-paid" basis, the shipper is required to pay at the point of origin all charges due any railroad which will handle the shipment. The usual method of handling rail freight, payment on the "collect" basis, allows the carrier at the point of destination to collect all charges. On the following month the railroads determine the net amount due from one road to another, and payment is made.

Robert H. Smith, treasurer of the Southern Railway Company, states in his affidavit:

> Money that is collected for another road is **not** treated as freight revenue (income) by the collecting road. On the other hand, it is not segregated and placed in a separate account, but is mingled with and used as working capital of the collecting road. . . . Any change in the usual practice by the railroad is likely to disrupt normal business relationships and cause serious inconvenience and expense to shippers and consignees.

It is clear that the Tennessee Central would have been placed in serious financial difficulties if all shipments which it handled were placed on a "pre-paid" basis by other carriers.

If the Tennessee Central had been forced to shut down its operations completely, it is a fair inference from this record that it would not have been possible for the trustee in reorganization to effectuate the sale of almost all of the road's line to the other three carriers which now operate it except possibly at a much reduced sales price. Once shippers had been forced to use means of transportation other than the railroad, they would have been reluctant to return to the railroad. As this Court has stated previously, the primary purpose of the Railroad Reorganization

Act is to keep existing railroad lines in operation whenever possible. *See* In re Tennessee Central Railway Company, Debtor, *supra.*

Two cases decided within the last ten years are advanced by the parties hereto as instructive on the issues presented here in deciding priorities among the various claimants. These are Southern Railway Company v. Flournoy, 301 F.2d 847 (4th Cir. 1962) and In re New York, New Haven & Hartford Railroad Company, 405 F.2d 50 (2d Cir. 1968), *cert. denied,* 394 U. S. 999. The United States cites the *New Haven* case in support of its priority, while the carriers place great reliance on the Flournoy opinion, and attempt to distinguish it from *New Haven.* The two cases are generally concerned with the competing priorities, in railroad reorganization proceedings, of six-months creditors and secured claimants, such as mortgagees and bond holders.

In the *New Haven* case, several unsecured creditors filed claims for services, parts and supplies, and sought a priority in payment under the six-months rule. The Court stated:

> Whether the six months creditors receive priority depends, however, on whether there existed a "current debt fund" or "current expense fund" from which payment could have been made but was used instead for the benefit of the bondholders. The reasoning behind the requirement of the current expense fund is that the six months claims deserve priority only to the extent that the claimants relied in extending credit on the availability of current income and not, along with others, on the railroad's general credit standing. *In re New York, New Haven and Hartford Railroad Company,* supra, at 52.

The reasoning is that six-months creditors should be allowed a priority only to the extent that there existed a

fund available for their payment which was diverted to the benefit of other creditors.

This rule was stated earlier by the District Court in the *New Haven* case in terms of providing a remedy to the six-months claimants when funds were improperly paid out on the mortgage debt before payment was made to current creditors whose extension of credit made continued operation of the road a possibility and thus benefited the mortgagees. The Court stated:

> Revenues accruing from operations should be paid first to the operations creditors whose materials and services made those revenues possible; and only after all such operational claims have been paid, should the balance be available for the benefit of the mortgagees. If any operating revenues do improperly get into the hands of the mortgagees, equity requires that those revenues be restored to the operations creditors by the mortgagees yielding them a priority. In re New York, New Haven & Hartford Railroad Co., 278 F. Supp. 592, 597-98 (D. Conn. 1967).

In the *Flournoy* case the Court ordered that a priority be given to the payment of interline balances, saying:

> Interline charges are, of course, contained in current revenues . . . Such transportation is art and part [sic] of our national railroad system. Indeed, it is compelled by statute. 49 U.S.C.A. §1, et seq.
>
> . . .
>
> With the District Court we agree that interline accounts are an equitable lien on the railroad properties and outrank the mortgages. Southern Railway Company v. Flournoy, *supra*, at 854.

The Fourth Circuit justified the payment of the interline traffic balances on the theory that if such accounts had not been paid, the other lines would have demanded pay-

ment, by placing the line on a "pre-paid" basis, thereby threatening the railroad's financial condition.

Neither the *New Haven* nor the *Flournoy* opinion seems to include a consideration of the true nature of these interline balances. The money collected by the Tennessee Central could not reasonably be considered a portion of its "operating revenues." The funds were not payment for any service rendered, or any goods sold, but monies rightfully due the carriers seeking priority. It is payment from shippers for haulage over the lines of these railroads which extended credit to the Tennessee Central.

There is no argument, however, that the Tennessee Central held these funds in trust for the other carriers. In In re the Central Railroad Company of New Jersey, 273 F. Supp. 282 (D. N.J. 1967), *aff'd per curiam*, 392 F.2d 589 (3rd Cir. 1968), the Court stated, regarding the nature of interline freight balances:

> That they [the interline freight balances] are not trust funds is clear. The relationship among the several carriers engaged in an interline freight movement is that of debtor and creditor. The AAR [American Association of Railroads] rules create no other relationship . . . While the interline freight balances are not trust funds, they may be entitled to preferential treatment under the so-called six-months rule, provided there is a compliance with the requirements thereof. *See* Southern Railway Company v. Flournoy, 301 F.2d 847 (4th Cir. 1962). [Some citations omitted.] In re The Central Railway Company, 273 F. Supp. at 288-89.

Thus, although the funds are not held in trust, the carriers can be said to have an equitable right to a priority in their recovery, if all other requisite requirements are met.

There is confusion among the parties seeking priority over the United States as to whether the six-months rule, or another rule, "the necessity of payment" rule, should be used to obtain the asserted priority. The Government resists assertion of either rule in behalf of other claimants. The rules differ only slightly in character. The necessity of payment rule was first enunciated in Miltenberger v. Logansport Railway Company, 106 U.S. 286 (1882), and is founded upon the theory that the payment of certain claims by the receiver or trustee may be necessary to the continued operation of the railroad, not, as in the six-months rule, that the payment is supported by equities in that they enabled continued operation, though perhaps not absolutely necessary. Mr. Justice Holmes stated in Gregg v. Metropolitan Trust Company, 197 U.S. 183, 187 (1905): "The ground of such allowance as was made [in Miltenberger] was not merely that the supplies were necessary for the preservation of the road, but that payment was necessary for the business of the road—a very different proposition."

In opposing application of the six-months rule, the United States contends that, under the rule, there must have been some diversion of funds from the operating revenues to the benefit of the mortgagees before the mortgaged corpus of the railroad can be charged with debts due the six-months creditors. This proposition was first set out in Fosdick v. Schall, 99 U.S. 235 (1878), and was recently restated in In re New York, New Haven and Hartford Ry. Co., *supra*. The Supreme Court noted in Southern Ry. Co. v. Carnegie Steel Co., 176 U.S. 257, 285 (1900): "[W]hen current earnings are used for the benefit of mortgage creditors before current expenses are paid, the mortgage security is chargeable in equity with the restoration of any funds thus improperly diverted from their primary use." Many courts, however, have taken the view that it is not necessary to show any diversion of

income, especially where it can be amply demonstrated that the railroad has derived some benefit from the services rendered by the creditors claiming an equitable priority. In Southern Ry. Co. v. Flournoy, *supra*, the Court stated:

> [W]e think income diversion to mortgage is not the sine qua non of corpus invasion where there are found —as special circumstances—all elements constituting the pre-eminent equity . . . Throughout them [cases discussing priorities and income diversion], however, runs the acknowledgment that, in special circumstances . . ., the general creditor partakes of liened capital assets ahead of the mortgagee. *Id.*, at 851.

Two Sixth Circuit cases, both more than sixty years old, touch upon the subject of priorities in railroad bankruptcy proceedings. Gregg v. Mercantile Trust Co., 109 F. 220 (6th Cir. 1901); and Gregg v. Metropolitan Trust Co., 124 F. 721 (6th Cir. 1903), *aff'd* 197 U.S. 183 (1905). Neither case is concerned with what priority should be afforded to the payment of interline traffic balances, but the Court stated in the Mercantile Trust case, *supra*, at 229:

> It is plain that the payment of car-trust obligations by the railroad company enhanced the interest of the mortgagees in such equipment. To the extent that such prior obligations were paid off, the mortgagees were benefited. Debts incurred for the purpose of making additions to the permanent equipment and motive power of a mortgaged railroad are not current operating expenses for supplies or materials, and are not preferential debts. If such debts would not be preferential debts if unpaid, their payment out of a fund primarily applicable to such debts is a diversion which the bondholders must make good if they were thereby benefited. [Citations omitted].

Thus, the Circuit Court was of the opinion, even then, that any expenditure which benefited the mortgagees was ipso facto a diversion, and payment thereof out of the mortgaged corpus is proper.

In the *Metropolitan Trust* case the Court of Appeals had established a claim for ties sold to a railroad in receivership as a six-months claim, but held that the claim could not be paid from the fund held by the receiver. The Supreme Court affirmed, but, after finding that there had been no diversion of income to the benefit of mortgagees, stated the issue as "whether in such a case a claim for necessary supplies furnished within six months before the receiver was appointed, should be charged on the corpus of the fund." 197 U.S. at 186. Finding "no special circumstances" or "equity" favoring the suppliers, the Court refused to charge the fund for the claims of suppliers ahead of the mortgagees. 197 U.S. at 186, 190. The Court thus seems to indicate that where there are special circumstances or equities favoring six-months claims, even in the absence of a diversion of income to the benefit of secured creditors, such claims might be allowed a priority in the assets.

The United States contends that the lack of any income for a lengthy period prior to the filing of the Tennessee Central's reorganization petition should have put the carriers on notice that there was no "current operating fund" from which these interline traffic balances could be paid. The carriers allege that their extension of credit, by handling the Debtor's interline balances on a "collect" basis,—unique to the operation of railroads—enabled the Tennessee Central to continue in operation through difficult financial straits, preserving the railroad as a "going concern" and facilitating the continuation of rail service to the vast majority of the area previously served by the Tennessee Central.

The equities in this case favor the priority of the carriers. Their extension of credit preserved the corpus of the mortgaged railroad by maintaining it as a "going concern," and at the same time enabling the area formerly served by the Tennessee Central to enjoy continued rail service, thereby carrying out the expressed purposes of the railroad reorganization section of the National Bankruptcy Act.

Therefore, the Court concludes that the carriers claiming priority under the six-months rule for interline freight balances should be given a priority over the United States, holder of the Debtor's bonds, and a mortgage on its property. Application of the six-months rule in this matter follows the criteria set forth in the *Flournoy* case, *supra*, and others. The maintenance of service through the carriers' extension of service was of benefit to the mortgagee, and hence their balances should be paid just as if some physical diversion of monies from current revenues had been of benefit to the mortgagee.

The United States is entitled to no statutory priority in this railroad reorganization action. Its claim is secured by the corpus of the mortgage, and it stands in this case as would any other bondholder or mortgagee. As the Court stated in In re Chicago Express, Inc., 222 F.Supp. 566 (S.D. N.Y. 1963); *aff'd* 332 F.2d 276 (2d Cir.) *cert. denied* 379 U.S. 879 (1964): "Where Congress intended that special priorities be granted, 'it has carefully enumerated them and any omissions must be construed as express exclusions . . .' ". [Citations omitted.] 222 F.Supp. at 571.

Another group of claimants seeking priority under the six-months rule includes three firms which leased freight cars to the Tennessee Central. The statement by these firms that the Tennessee Central operated with only six or seven freight cars of its own, leasing the remainder, is

unchallenged by the United States. According to the brief of one of the leasing companies, the Tennessee Central was almost unique in this respect, in that it operated almost totally with leased cars.

In its brief the United States says simply, "Finally items such as car rentals are not allowable," citing Thomas v. Western Car Co., 149 U.S. 95 (1893), and In re Chicago and N.W. R. Co., 110 F.2d 425 (7th Cir. 1940).

Louis O. Sloss, secretary-treasurer of the Chicago Freight Car Leasing Company, one of the leasing claimants, states in his affidavit that the firm allowed the Tennessee Central to continue the use of the cars for a six-month period prior to the filing of the petition in reorganization in reliance on the six-months priority rule. Sloss also stated that if Chicago Freight Car Leasing had recalled all the cars upon the cessation of payment, in July, 1967, the Tennessee Central would have been unable to operate.

In the Thomas case, *supra*, the Court disallowed the granting of priority to the car rental firm there involved, saying:

> [T]he principal officers of the car company were in control of the railroad company and its operations, and must be treated as having full notice of the financial condition of the railroad company, and as having leased the cars to it in reliance upon its general credit, rather than in expectation of displacing the priority of mortgage liens. Thomas v. Western Car Co., *supra*, at 112.

The Court also stated:

> The case of a corporation for the manufacture and sale of cars, dealing with a railroad company, whose road is subject to a mortgage securing outstanding bonds, is very different from . . . those who furnish,

> from day to day, supplies necessary to the maintenance of the railroad.
>
> . . .
>
> In the present case it appears, in the contract between the car company and the railroad company, that the former reserved the express right to terminate the contract and demand possession of the cars forthwith upon any failure by the railroad company to promptly pay the interest or the principal of any of its bonds or other liabilities. 149 U.S. at 112.

The Thomas case was, of course, decided long before the enactment of the railroad reorganization section of the National Bankruptcy Act, the purpose of that act being to keep existing railroads in operation. If, as the Court suggests in *Thomas,* the freight car leasing companies in this case had withdrawn their cars at the first sign of financial difficulties, the Tennessee Central would have been forced to suspend operations immediately.

In the *Chicago* case, there is no showing that the Pullman cars there in issue were necessary to the operation of the road. Also the controversy involved not the payment of actual rental for the cars, but the lighting and mileage charges on them. Moreover, the cases seem to draw a distinction between "car rentals" and "materials and supplies." *See* In re Chicago & N.W. R. Co., *supra,* at 431. In the case of the Tennessee Central, operating almost wholly with leased cars, the leasing of these cars should be treated as analogous to buying "materials and supplies."

In any case, the central point is whether the goods or services supplied by the creditor seeking priority under the six-months rule were necessary for the continuation of service on the debtor railroad. Without any doubt, the Tennessee Central could not have operated at all without the freight cars which it leased from the Chicago

Freight Car Leasing Company, Trailer Train Company, and American Refrigeration Transit. Therefore, these companies are entitled to the same priority under the six-months rule as the carriers seeking recovery of interline freight balances.

Several municipalities and counties along the line of the Tennessee Central have filed claims for taxes, and the interest and penalties thereon, for the years 1966 and 1967. The Court has already determined that the United States is entitled to no priority under 31 U.S.C. §191, and that the United States stands in the position of any bondholder and mortgagee in a similar case. It must now be determined whether these governmental units are entitled to recovery of the taxes against the corpus of the mortgage, whether these taxing units will be allowed to recover interest and/or penalties, and what priority should be given to such recovery, if granted.

Tennessee law provides:

> The assessed taxes on all real estate, personalty, railroad, telegraph, and telephone, and other public service companies, and all damages and costs accruing thereon, shall be and remain a first lien upon such property, from the tenth of January of each and every year, for the taxes of that year. Tenn. Code Ann. §67-1801.

Tennessee law is applicable on this point, and therefore, taxes should be accorded first priority in recovery, ahead of the six months creditors, if it is determined that under the provisions of the National Bankruptcy Act, this Court has jurisdiction to approve the claim.

The Supreme Court said in Gardner v. New Jersey, 329 U.S. 565 (1947):

> We think, contrary to the position of New Jersey, that the reorganization court has jurisdiction over

> the proof and allowance of tax claims and that the exercise of that power was not a suit against the state. . . . We find not the slightest suggestion that Congress left out the large class of tax claims which recurringly appears in reorganizations and often assumes, as here, large proportions. 329 U.S. at 572-73.

The National Bankruptcy Act contains a provision disallowing claims of states or other taxing units for penalty claims:

> Debts owing to the United States or any State or subdivision thereof as a penalty or forfeiture shall not be allowed, except for the amount of the pecuniary loss sustained by the act, transaction, or proceeding out of which the penalty or forfeiture arose, with reasonable and actual costs occasioned, thereby and such interest as may have accrued thereon according to law. National Bankruptcy Act §57j, 11 U.S.C. §93(j).

A portion of the railroad reorganization section of the bankruptcy act seems to apply section 57(j) to railroad cases:

> In proceedings under this section and consistent with the provisions thereof, the jurisdiction and powers of the court, the duties of the debtor and the rights and liabilities of creditors, and of all persons with respect to the debtor and its property, shall be the same as if a voluntary petition for adjudication had been filed and a decree of adjudication had been entered on the day when the debtor's petition was filed.

In a case involving the lengthy reorganization of the New York, New Haven & Hartford Railroad, the Court of Appeals for the Second Circuit held that the tax liabilities of a railroad which were incurred prior to the consummation of the reorganization plan would be paid as a cost of administration. *See* In re New York, New

Haven & Hartford R. Co., 147 F.2d 40, 52-53 (2d Cir. 1945). Another case holding that §57(j) of the Bankruptcy Act applies to railroad reorganization proceedings is In re Denver & R. G. W. R. Co., 27 F.Supp. 983 (D. Colo. 1939).

There is no question that the taxes owed the municipalities and counties filing timely claims in this matter should be paid by the Trustee. As for interest, the Supreme Court held recently in Nicholas v. United States, 384 U.S. 678 (1966), that interest should not be allowed in an ordinary bankruptcy proceeding in order to effectuate "the broad equitable principle that creditors should not be disadvantaged vis-a-vis one another by legal delays attributable solely to the time-consuming delays inherent in the administration of the bankruptcy laws." *Id.*, at 683. The Court further held that the Trustee in bankruptcy would be liable for the penalties incurred through the non-payment of taxes when such penalties were imposed "solely because of the trustee's failure to file timely returns for the taxes incurred. . . ." *Id.*, at 695.

In the instant case, no penalties have been incurred through any failure of the Trustee to file timely returns. All taxes which have fallen due subsequent to the filing of the petition in reorganization on December 14, 1967, have been paid. The penalties are for delinquent taxes which accrued prior to this date.

Tennessee law grants these taxing units a "first lien" on the property of the Tennessee Central. It is stated in 5 *Collier on Bankruptcy* (14th ed.) ¶77.21 that: "Whenever tax claims are accorded a priority, even under 31 U.S.C. § 191, they will not supersede valid liens, or the priorities accorded administrative and operating costs or claims under the six months rule." Therefore, the municipalities and counties should not be granted a priority over the six months claimants unless they possess a valid lien

for their tax claims. The Court is of the opinion that the applicable Tennessee statute grants such a lien to these taxing units. Earlier, in *Collier, id.*, it is noted: "With respect to state taxes, many state statutes grant a priority for claims thereon, and this priority will be recognized by the court." The statutory priority granted by § 67-801, *T.C.A.*, governs in this case. Therefore, these counties and municipalities will be granted first priority in this recovery, ahead of both the six-months claimants, and the United States, as mortgagee and bondholder. No payment will be allowed as to the penalities which have been attached to these delinquent taxes, since the penalties have been in no way connected with any delay on the part of the Trustee. Interest on these taxes will be allowed only to the extent that it accrued prior to December 14, 1967. To allow the payment of any interest which accrued subsequent to this date would be unfair to the other creditors.

The Koppers Company has filed a claim in this action, claiming priority both under the six-months rule, and under Tenn. Code Ann. § 65-1021, which provides:

> No railroad company shall have power to give or create any mortgage or other kind of lien on its railway property in this state, which shall be valid and binding against judgments and decrees, and executions therefrom, for timbers furnished and work and labor done on, or for damages done to persons and property in the operation of its railroad in this state. T.C.A. § 65-1021.

Koppers sought recovery for approximately $120,000.00 worth of cross-ties furnished to the Tennessee Central.

Whether or not Koppers would be entitled to recover under the six-months rule, it seems clear that it is due a priority by virtue of the applicable Tennessee lien statute. There is no need for the Court to reach the question of recovery under the six-months rule, since Koppers will

be allowed second priority in recovery against the corpus, following the taxing units, and preceding the six-months creditors.

While it is true that Koppers did not at any time perfect its statutory lien against the property of the Tennessee Central, the company states that the perfection of the lien was not carried out because of the injunction of this Court, holding all matters regarding the railroad's financial status in abeyance pending disposition of the reorganization proceeding. It is not necessary for Koppers to have formally perfected its lien against the Debtor. The intent of the Tennessee statute is clear, and Koppers and its claim fall within the ambit of the law.

The final claim which the Court must consider is that of the Humble Oil & Refining Company. Humble supplied the Tennessee Central with substantial amounts of diesel fuel during the six months preceding the filing of the reorganization petition, and asserts a priority under the six-months rule. Humble contends in its brief that this fuel was "material necessary for the continued operation of the railroad."

It is not clear that the extension of credit from Humble was indispensable for the Tennessee Central to continue in operation during the six months prior to reorganization. For it is possible that some other fuel supplier might have extended this credit if Humble had refused to do so. Nevertheless Humble's claim meets all of the criteria for application of the six-months rule as formulated in Guaranty Trust Co. v. Albia Coal Co., *supra*. Some fuel was certainly necessary to the continued operation of the road, and Humble was willing to supply it. The position of Humble is analogous to that of the freight car leasing companies. If the Debtor had been deprived of either freight cars, or a supply of diesel fuel at the first sign of financial difficulties, it would have been shut down almost immediately.

The Court is of the opinion that Humble was, in this case, extending credit against current earnings within the contemplation of the six-months rule. Therefore, Humble is entitled to recover along with the other six months claimants.

This case represents a lengthy and unique exercise in railroad reorganization. As was discussed in this Court's opinion at 304 F.Supp. 789 (M.D. Tenn. 1969), the reorganization of the Tennessee Central was accomplished not through a restructuring of the existing corporate shell, but through the sale of virtually all of the Debtor's operating lines to other carriers, who have to this day continued service to all but a minute portion of the Tennessee Central's former area of service.

The Court's exercise of jurisdiction in this matter is basically a matter of equity. The six-months rule is itself a creature of equity. The Court must look to the equities of the individual situation in order to arrive at a decision. The primary consideration in the application of the six-months rule, in light of the declared purpose of the reorganization act to keep railroads in operation, is whether the creditor claiming a priority under the rule was a vital factor in the continued operation of the road.

In light of the expressed desire of Congress that railroads be kept in operation whenever possible, it must be assumed by the Court that it is more valuable to have the vast majority of the Tennessee Central trackage presently operated by other carriers, than to have the service discontinued altogether. The creditors who have kept the railroad in operation have thus benefitted the mortgagee and bondholder, the United States, by preserving the service formerly provided by the Tennessee Central, thus enabling the trustee to sell the road as a going concern

and to realize a greater return that would have been the case if he had been forced to sell the physical properties of the road after it had closed down.

A form of judgment will be submitted to accomplish these results.

/s/ WILLIAM E. MILLER
Circuit Judge Sitting as
District Judge by Designation

In the District Court of the United States
for the Middle District of Tennessee
Nashville Division

In the Matter of: Tennessee Central Railway Company, Debtor.	In Proceedings for the Reorganization of a Railroad No. BK 67-2263

Supplement to Opinion of August 19, 1970
Entered August 27, 1970

While this case was under advisement, the United States Supreme Court decided the case of United States v. Key, 397 U.S. 322 (1970). This case was not cited in any of the briefs before the Court, but was called to the attention of the Court by the attorney for the Trustee in the instant proceedings. Because the Court did not discuss the *Key* case in its opinion of August 19, 1970, this Supplement thereto is entered in the interest of completeness.

In United States v. Key, *supra*, the Supreme Court held that Stat. § 3466, 31 U.S.C.A. § 191, a provision giving a first priority to debts owed to the United States by an insolvent debtor, is applicable to tax claims of the Government in corporate reorganization proceedings under Chapter X of the National Bankruptcy Act, 11 U.S.C. §§ 501-676. In discussing the history of the reorganization provisions of the Act, Mr. Justice Marshall stated, in part:

> Section 77 [relating to railroad reorganizations] . . . was designed to follow the general format of the equity receivership. . . . However, the problems of the equity receivership that led to the legislative intervention did not include the Government's priority

> under § 3466, a relatively uncontroversial aspect of the receivership procedure.
>
> Nothing in § 77 casts any doubt on the continued priority of the United States under § 3466. 397 U.S. at 330.

The opinion goes on to reason that the corporate reorganization provisions, later enacted by Congress and modeled closely after the railroad reorganization provisions, contain no provision indicating that Stat. § 3466 should not apply in Chapter X reorganizations.

It is the Court's opinion that the language in the *Key* case relating to the applicability of Stat. § 3466 to railroad reorganization proceedings is clearly dictum because the issue before the Supreme Court in *Key* was the applicability of Stat. § 3466 to Chapter X proceedings, and the reference to its applicability to railroad reorganizations was merely incidental to the decision on that one issue. Therefore, the *Key* case does not constitute precedent for allowing the Government's claim for a first priority in the assets of the Tennessee Central in the instant proceeding.

WM. E. MILLER
Circuit Judge Sitting as District
Judge by Designation

APPENDIX D

Received for Entry,
11:00 A.M.
October 9, 1970
Brandon Lewis, Clerk
By: Guy W. Cooper, D.C.

In the United States District Court
for the Middle District of Tennessee
Nashville Division

In the Matter of Tennessee Central Railway Company, Debtor.	In Proceedings for the Reorganization of a Railroad. No. BK 67-2263

JUDGMENT
No. 94

Dividing Creditors and Stockholders Into Classes According to the Nature of Their Claims, Setting Up Classifications of Creditors and Stockholders, Determining the Order of Priority of Claims and Directing Report by Trustee.

A. Battle Rodes, Trustee of Tennessee Central Railway Company, the above named Debtor, having petitioned the Court for a hearing on the division of creditors and stockholders into classes according to the nature of their claims and interests and for a determination of the order of priority of such claims, and a hearing on these issues having been held on November 10, 1969, after notice to all parties in interest, at which hearing United States of America, various railway companies claiming priorities, other creditors claiming priorities, and several counties and municipalities were represented by counsel, affidavits

were presented, arguments of counsel were heard and briefs were filed within the time allowed by the Court for the filing of briefs, and all parties were given opportunity to present evidence, to be heard, to file briefs, and no counsel having appeared on behalf of general creditors or on behalf of stockholders, and the Court having filed its memorandum opinion, including its findings of fact, conclusions of law and order for judgment on August 19, 1970, with supplemental memorandum opinion on August 27, 1970; now, therefore, pursuant to said order for judgment;

It Is Hereby Ordered and Adjudged that:

1. The classification of creditors and stockholders, the division of creditors and stockholders of the Debtor into classes according to the nature of their respective claims and stock interests, and the order of priority of such claims and interests be, and they hereby are, fixed as follows:

(i) Expenses and costs of administration and operation of Tennessee Central Railway Company commencing December 14, 1967, and costs and expenses incurred in this cause under orders of the Court;

(ii) Claims for personal injuries to employees of Tennessee Central Railway Company, and claims of personal representatives of deceased employees of Tennessee Central Railway Company, arising under state or federal laws and accruing prior to December 14, 1967;

(iii) Claims of counties and municipalities of the State of Tennessee for taxes assessed and unpaid on December 14, 1967, without penalty, but with interest thereon to the extent that interest had accrued prior to December 14, 1967;

(iv) Claims for timbers furnished and work and labor done on, or for damages done to persons and property

(other than injuries to employees) in the operation of Tennessee Central Railway Company in the State of Tennessee prior to December 14, 1967, as provided under Section 65-1021, Tennessee Code Annotated;

(v) Claims against Tennessee Central Railway Company for interline freight balances in favor of other railway companies arising within six months prior to December 14, 1967, claims against Tennessee Central Railway Company for amounts owing for car rentals or leasing of cars to Tennessee Central Railway Company accruing within six months prior to December 14, 1967, and claims for fuel supplied to Tennessee Central Railway Company for operation of the motive equipment of that company accruing within six months prior to December 14, 1967;

(vi) Claims of United States of America for indebtednesses due United States of America by Tennessee Central Railway Company represented by notes held by Treasury Department of United States of America, the payment of which is secured by the pledge of the First Mortgage Series A Bonds of Tennessee Central Railway Company;

(vii) General claims against Tennessee Central Railway Company, including claims of general creditors and claims or interests (exclusive of stockholder interests) of whatever character, other than those hereinabove enumerated;

(viii) Claims of interest of preferred stockholders of Tennessee Central Railway Company;

(ix) Claims of interest of common stockholders of Tennessee Central Railway Company.

2. A. Battle Rodes, Trustee, shall proceed with the classification of the specific claims filed and not objected to in the order of priority as hereinabove established, and shall report to the Court all outstanding and unsatisfied claims and the amounts of such claims as shown upon the claims register and in the order of priority as hereinabove stated.

3. Upon the filing of such report by the Trustee, the Court by appropriate order will direct the distribution of copies thereof to the several parties in interest, will provide for the filing of objections to such report, and will enter an appropriate order referring to Honorable Fred Elledge, Jr., Special Master, any objections to the amounts and priority classifications as set out in the Trustee's report, for the taking of evidence thereon and reporting the Special Master's findings and recommendations to the Court. The report of the Trustee as provided for in this order shall remain open for amendment as to classifications, amounts and priorities of claims until the findings and recommendations of the Special Master on the items referred to him have been reported to, and acted upon by the Court.

4. The Special Master shall proceed with the hearing of objections heretofore filed to claims and now pending before him, and shall report to the Court his findings and recommendations thereon.

5. The Trustee on or before October 17th, 1970, shall cause a copy of this order and a copy of the following notice to be mailed to each of the mortgage trustees, creditors whose claims have not been withdrawn or settled and stockholders of the Debtor at their last known addresses as the same appear upon the books and records of the Debtor, or as may be known to the Trustee:

Notice of Judgment Dividing Creditors and Stockholders Into Classes According to the Nature of Their Claims, Setting Up Classifications of Creditors and Stockholders, Determining the Order of Priority of Claims and Directing Report by Trustee

In the United States District Court
for the Middle District of Tennessee

Nashville Division

In the Matter of Tennessee Central Railway Company, Debtor.	In Proceedings for the Reorganization of a Railroad. No. BK 67-2263

To All Mortgage Trustees, Creditors, Stockholders and Parties in Interest:

Please take notice that on October 9, 1970, Honorable William E. Miller, Judge, U. S. Court of Appeals for the Sixth Circuit, acting as District Judge, entered the attached judgment in this case dividing creditors and stockholders into classes according to the nature of their claims, setting up classifications of creditors and stockholders, determining the order of priority of claims, and directing a report by the Trustee.

Please take further notice that this judgment will become final as to the classifications and order of priorities of claims and interests of stockholders within the time provided by law in such cases following the date of the entry of the judgment.

Please take further notice that the matter of individual claims, the amounts thereof, and the classification by priority into which an individual claim falls will be reported by the Trustee subject to objections by interested parties after the report has been filed.

Please take further notice that a copy of the report of the Trustee will be mailed to mortgage trustees, creditors and stockholders and other parties in interest when the report is filed.

Dated at Nashville, Tennessee, this October 16, 1970.

A. Battle Rodes
Trustee of Tennessee Central Railway Company

This 7th day of October, 1970.

/s/ WILLIAM E. MILLER
Judge

/s/ CARMACK COCHRAN
Attorney for A. Battle Rodes, Trustee

APPENDIX E

United States Court of Appeals for the Sixth Circuit

In the Matter of:

Tennessee Central Railway Company,
Debtor,
United States of America,
Plaintiff-Appellant,
vs.
A. Battle Rodes, Trustee of Tennessee Central Railway Company,
Defendant-Appellee.

No. 71-1228.

ORDER

(Filed April 4, 1971)

Before: Weick, Edwards and Peck, Circuit Judges.

Petitions for rehearing and a suggestion for rehearing in banc having been filed by defendants-appellees in the above-styled case, and no judge of this court having moved for rehearing in banc and the petition for rehearing having been assigned to the panel which heard the case, with Judge Paul C. Weick designated to serve in place of Judge Henry L. Brooks, deceased, said petitions are hereby denied, for the reasons set forth in the opinion of the court.

Entered by order of the Court.

JAMES A. HIGGINS
Clerk

APPENDIX F

RELEVANT SECTIONS OF § 77 OF THE NATIONAL BANKRUPTCY ACT

(11 U.S.C. § 205; 49 Stat. 911)

Section 77(b) (11 U.S.C. 205(b))

* * * * * * * *

The term "claims" includes debts, whether liquidated or unliquidated, securities (other than stock and option warrants to subscribe to stock), liens, or other interests of whatever character. For all purposes of this section unsecured claims, which would have been entitled to priority if a receiver in equity of the property of the debtor had been appointed by a Federal court on the day of the approval of the petition, shall be entitled to such priority and the holders of such claims shall be treated as a separate class or classes of creditors.

* * * * * * * *

Section 77(e) (11 U.S.C. 205(e))

* * * * * * * *

(e): *Provided further,* That if, in any reorganization proceeding under this section, the United States is a creditor on claims for taxes or customs duties (whether or not the United States has any other interest in, or claim against, the debtor, as creditor or stockholder), no plan which does not provide for the payment thereof shall be confirmed by the judge except upon the acceptance, certified to the court, of a lesser amount by the President of the United States or the officer or agency designated by him pursuant to the provisions of the preceding paragraph hereof: *Provided further,* That if the President of the

United States or such officer or agency shall fail to accept or reject such lesser amount for more than ninety days after receipt of written notice so to do from the court, accompanied by a certified copy of the plan, the consent of the United States insofar as its claims for taxes or customs duties are concerned shall be conclusively presumed.

* * * * * * *

APPENDIX G

ACT MARCH 3, 1797, CH. 20, § 5, 1 STAT. 515
ACT MARCH 2, 1799, CH. 22, § 65, 1 STAT. 676
R.S. § 3466 (31 U.S.C. § 191)

§ 191. Priority established

Whenever any person indebted to the United States is insolvent, or whenever the estate of any deceased debtor, in the hands of the executors or administrators, is insufficient to pay all the debts due from the deceased, the debts due to the United States shall be first satisfied; and the priority established shall extend as well to cases in which a debtor, not having sufficient property to pay all his debts, makes a voluntary assignment thereof, or in which the estate and effects of an absconding, concealed, or absent debtor are attached by process of law, as to cases in which an act of bankruptcy is committed. R.S. § 3466.

APPENDIX H

RELEVANT PORTION OF 15 U.S.C. 603

Reconstruction Finance Corp.

§ 603. Period of succession; employment of personnel; priority of debts due Corporation; death or injury benefits of employees

* * * * * * * *

Debts due the Corporation, whether heretofore or hereafter arising, shall not be entitled to the priority available to the United States pursuant to section 191 of Title 31 except that the Corporation shall be entitled to such priority with respect to debts arising from any transaction pursuant to any of the following Acts or provisions in effect at any time: Sections 5d(1) and 5d(2) of the Reconstruction Finance Corporation Act added by section 5 of the Act entitled "An Act to authorize the purchase by the Reconstruction Finance Corporation of stock of Federal home-loan banks; to amend the Reconstruction Finance Corporation Act, as amended, and for other purposes", approved June 25, 1940 (54 Stat. 573); sections 4(f) and 9 of the Act entitled "An Act to mobilize the productive facilities of small business in the interests of successful prosecution of the war, and for other purposes", approved June 11, 1942 (56 Stat. 354, 356); section 2(e) of the Emergency Price Control Act of 1942 (56 Stat. 26); the Surplus Property Act of 1944 (58 Stat. 765 and the following); sections 11 and 12 of the Veterans' Emergency Housing Act of 1946 (60 Stat. 214, 215); and section 403 of the Sixth Supplemental National Defense Appropriation Act (56 Stat. 245).

* * * * * * * *

APPENDIX I

RELEVANT SECTIONS OF REORGANIZATION PLAN NO. 1 OF 1957, Effective June 30, 1957,

22 F.R. 4633, 71 Stat. 647

Reorganization Plan No. 1 of 1957
Eff. June 30, 1957, 22 F.R. 4633, 71 Stat. 647

Prepared by the President and transmitted to the Senate and the House of Representatives in Congress assembled, April 29, 1957, pursuant to the provisions of the Reorganization Act of 1949, approved June 20, 1949, as amended.

Abolition of the Reconstruction Finance Corporation

Section 1. Definitions. As used in this reorganization plan:

(a) The term "Corporation" means the Reconstruction Finance Corporation.

(b) The term "remaining functions" means (1) all functions of the Corporation, (2) except as otherwise provided in subsections (b) and (c) of section 6 of this reorganization plan, all functions of the Secretary of the Treasury under section 10 of the Reconstruction Finance Corporation Act, as amended (15 U.S.C.A. 609) [section 609 of this title], and (3) all functions of the Secretary of the Treasury under sections 102 and 106(b) of the Reconstruction Finance Corporation Liquidation Act (67 Stat. 230, 231), as amended [sections 603 and 609 note of this title].

* * * * * * * *

(d) There are hereby transferred to the Secretary of the Treasury all functions of the Corporation not otherwise transferred by the provisions of this reorganization

plan, including, but not limited to, all functions of the Corporation with respect to or arising out of (1) programs of financial assistance to railroad companies, financial institutions, and insurance companies, (2) the obligations and loans listed in Schedule A hereto annexed, and (3) the War Damage Corporation.

(e) The foregoing transfers include the transfer to each transferee, for use in executing his respective functions thereunder, of the powers, authority, rights, and immunities now vested in or available or applicable to the Corporation for carrying out the functions transferred to the transferee under this reorganization plan.

Sec. 3. Transfer of assets and liabilities. The loans, obligations, securities, capital stock, and other assets pertaining to the functions transferred by section 2 of this reorganization plan (including accrued interest thereon, and property acquired in connection therewith) and the liabilities, contracts, bonds, mortgages, notes and other instruments relating thereto are hereby transferred from the Corporation to the respective transferees: Provided, however, That all assets, liabilities, and commitments relating to the functions transferred by section 2(a) of this reorganization plan are hereby transferred to the Revolving Fund (Liquidating Programs) established by the Independent Offices Appropriation Act, 1955 (68 Stat. 295) [section 1701g-5 of Title 12].

* * * * * * *

APPENDIX J

RELEVANT SECTION OF § 77 (1933); 47 Stat. 1474, Section C. (Entire § 77 (1933) reprinted in note to 11 U.S.C.A. 205.)

For all purposes of this section claims against a railroad corporation which would have been entitled to priority over existing mortgages if a receiver in equity of the property of the debtor had been appointed by a Federal court at the date of the filing of the petition hereunder shall be entitled to such priority, and holders of such claims shall be treated as a separate class of creditors.